

Exchange Traded Funds: Leveraging insight to deliver operational efficiency

CIBC MELLON



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“As the needs of investment fund companies change in response to further regulation, investor demands and market fluctuations, CIBC Mellon will be ready with the latest technology and integration solutions.”

Since the early nineties, Exchange Traded Funds (ETF) have been playing an increasingly prominent role in the portfolios of institutional and retail investors alike. Liquidity, transparency and the fee structure of ETFs have given them a presence and appeal that resonate well in today's highly volatile market. Risk focused managers are looking to ETFs as a source of diversification and hedging. Institutional investors see the potential of being a market maker. Sophisticated retail investors understand the accessibility and leverage that ETFs can offer. Collectively the appeal has resulted in a more than 200 per cent increase in assets in Canada since June 2006.

CIBC Mellon has been actively supporting the ETFs market since 2002 and is proud to be recognized as a leading provider of ETF solutions in Canada. CIBC Mellon understands this marketplace and its unique needs. Over the years, we have successfully leveraged our asset servicing expertise to create a solution designed to support the entire lifecycle of a fund. From initial setup through basket creation and order taking, CIBC Mellon delivers efficiency of process and access to information.

What is an Exchange Traded Fund?

The ETF space in Canada, when compared with mutual funds is relatively small, but rapidly growing. ETFs bring together the best of the equity and mutual fund markets. The 2011 Investment Company Fact Book describes an ETF as “an investment company, typically an open-ended investment company (open-ended fund) or unit investment trust, whose shares are traded intraday on stock exchanges at market-determined prices.” The New York Stock Exchange defines an ETF as “an investment product that allows an investor to buy and sell shares in a single security that represents a fractional ownership of a portfolio of securities.”¹ Both definitions highlight how ETFs combine the sophistication and diversification of unit trust investing with the liquidity and accessibility of trading intraday on stock exchanges.



The creation and redemption of ETF shares

There are a few key participants in the ETF space, each with their own focus (Figure 1):

- **The Fund:** the investment fund company which designs the investment objectives, creating the corresponding basket of securities, issuing the shares and managing the portfolio.
- **Transfer Agent:** the holding company for the ETF shares or the assets of the fund.
- **Designated Broker:** typically institutional investors which are able to create shares of the ETF through basket creation or in-kind transfers. In US markets, these brokers are often referred to as Authorized Participants.
- **Asset Servicing Provider:** the recordkeeper and safekeeper of the securities that compose the ETF. Facilitates trades and activities of the Fund and Designated Broker.
- **Central Depository for Securities:** the depository for securities and facilitation of trading on the Canadian stock exchanges.

The Investment Company Fact Book 2011 explains that “ETF shares are created when [a designated broker] - typically a large institutional investor, such as a market maker or specialist—deposits the daily creation basket and/or cash with the ETF. The ETF may require or permit [a designated broker] to substitute cash for some or all of the securities or assets in the creation basket. In return for the creation basket and/or cash, the ETF issues to the [designated broker] a “creation unit” that consists of a specified number of ETF shares. Creation units are large blocks of shares that generally range in size from 25,000 to 200,000 shares. The [designated broker] can either keep the ETF shares that make up the creation unit or sell all or part of them on an exchange. ETF shares are listed on a number of exchanges where investors can purchase them as they would shares of a publicly traded company.

A creation unit is liquidated when [a designated broker] returns the specified number of shares in the creation unit to the ETF. In return, the [designated broker] receives the daily “redemption basket,” a set of specific securities and/or other assets contained within the ETF’s portfolio. The composition of the redemption basket typically mirrors that of the creation basket.”²

In the past, ETFs were mainly focused on replicating an index. Primarily a passive investment strategy, investment companies created baskets of securities designed to replicate an index. Most recently, active investment strategies have been applied as investors see value in creating hedges around an industry, sector or commodity. Within this rapidly expanding environment, choosing the right asset servicing provider becomes critically important to success for those creating ETFs.

A unique solution built on insight

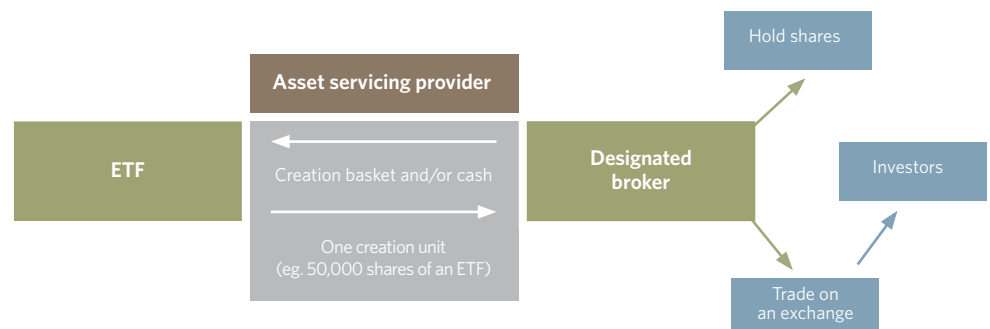
CIBC Mellon is once again responding to the needs of investment companies with targeted, strategically appropriate services. We have identified three key functions as critically important to supporting ETFs: basket creation (iNAV), trade settlement and verification, and order taking.

First, indicative net asset values, or iNAVs are tomorrow's opening price for the ETF, calculated today. Using the information available to them, fund managers themselves have typically calculated this value at the end of each day. Powered by a fully integrated platform, however, CIBC Mellon is able to more precisely estimate the iNAV by leveraging a unique view to the pricing and settlement status of trades across a wide-range of securities. This not only saves effort, but also allows the fund to publish more accurate prices in a timely fashion.

The trade settlement and verification process is another area where CIBC Mellon has developed a tailored solution. Our knowledge and understanding of the lifecycle of a trade and our well established links with central depositories gives us the ability to see the entire process. We are therefore better able to identify and correct issues quickly and ultimately get the shares to market faster. Typically involving the entry, execution and verification of many individual trades before a new share(s) can be released, CIBC Mellon respects the time-sensitive complexity required to create an ETF share. As custodian and safekeeper of securities in many different portfolios, we are able to readily verify and approve trades for settlement.

Recognizing opportunities to further drive efficiencies, CIBC Mellon recently introduced a centralized order process. Now, designated brokers can simply enter a trade order which creates all necessary orders for the basket creation and notifies all parties (transfer agent, fund company and designated broker) of the status of the trade. This level of communication could prove invaluable in active and aggressive market spaces.

Figure 1: Creation of an ETF



Partnering for future success

When investment companies look for an asset servicing provider to deliver on their needs, they turn to CIBC Mellon. We are pleased to have been the asset servicing provider of choice for five of the seven ETF providers listed in Canada since February 2011. In addition, CIBC Mellon proudly delivers the strength and capabilities of BNY Mellon to Canada. BNY Mellon has quickly established itself as the global leader in the ETF market and has recently launched EPIC, a leading-edge, full service ETF solution. EPIC not only uses the latest technology solutions from the world's largest asset servicing provider, but effectively links ETFs with powerful efficiency and cost saving generating solutions.

Joe Keenan, Managing Director, for Global Exchange Traded Service at BNY Mellon, in a recent Global Custodian article outlined the functionality of EPIC as "in essence powerful middleware. EPIC takes data from our core accounting platform, from the index providers when the products are based upon underlying benchmarks or from the client if they are actively managed products, and based upon customized rule sets, calculates the investable basket each and every day. We then disseminate that basket as a communication provider out to the street, so that those institutions know each and every day what securities and cash they need to deliver, or will receive if they create or redeem with the particular fund. Those two tools, the API and EPIC, communicate with each other so that we can manage and maintain the order flow in a highly automated and efficient manner."³

As the needs of investment fund companies change in response to further regulation, investor demands and market fluctuations, CIBC Mellon will be ready with the latest technology and integration solutions. We deliver asset servicing excellence to ensure that managers are able to focus on their business objectives.

For further information, please contact:

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About CIBC Mellon

CIBC Mellon currently services approximately 33% of Canadian assets. Our client base is comprised of approximately 1,100 relationships representing 1,000 domestic clients and more than 80 foreign financial institutions; total assets under administration were more than CA\$1.1 trillion, as at June 30, 2011.

Our clients include Canadian pension funds, investment funds, corporations, government, insurance companies, foreign insurance trusts, foundations and foreign financial institutions whose clients invest in Canada. We work in partnership with our clients to increase operational efficiencies, manage risk, and increase performance.

Built on the strengths and traditions of our two parent companies: Canadian Imperial Bank of Commerce (CIBC) and The Bank of New York Mellon Corporation (BNY Mellon), CIBC Mellon strives to design and deliver reliable asset servicing solutions to institutional investors operating in Canada. We first began offering asset services to institutional investors in 1996, when CIBC joined forces with Mellon Financial Corporation (Mellon) to form a 50/50 joint venture—CIBC Mellon Global Securities Services Company. On July 1, 2007, Mellon—our U.S. parent company—merged with The Bank of New York Company Inc. to form the 11th-largest financial services company in the world. As a result of this merger, BNY Mellon is now the global leader in asset servicing with more than US\$26.3 trillion in assets under custody and administration.

For further information about CIBC Mellon, please visit cibcmellon.com.

¹ "What you should know about Exchange Traded Funds." NYSE Informed Investor Series. NYSE Regulation. Copyright 2009.

² "Exchange Traded Funds." 2011 Investment Company Fact Book. 51st edition. Investment Company Institute. Copyright 2011.

³ Keenan, Joe. "ETFs: Growing up." Global Custodian, Summer Plus 2011. pp 20-21.



➤ A BNY MELLON AND CIBC JOINT VENTURE COMPANYSM

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